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Samuel C. Thompson Jr.

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# A COMPARISON OF THE MERGER AND ACQUISITION PROVISIONS OF PRESENT LAW WITH THE PROVISIONS IN THE SENATE FINANCE COMMITTEE'S DRAFT BILL†

SAMUEL C. THOMPSON, JR.\*

## SECTION I: SCOPE

This paper compares the present law governing mergers and acquisitions with the changes that have been proposed by the Staff of the Senate Finance Committee. The proposed rules are set forth in the September 22, 1983 Committee Print of the Staff of the Senate Finance Committee entitled *The Reform and Simplification of the Income Taxation of Corporations* (hereinafter referred to as SFC Report).<sup>1</sup> The SFC Report is based on the American Law Institute's proposals in *Corporate Acquisitions and Dispositions* which is set forth in the Institute's *Federal Income Tax Project, Subchapter C* (hereinafter referred to as ALI Report).<sup>2</sup>

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† I would like to thank Paul R. Wysocki of Schiff, Hardin & Waite for his helpful comments on this article.

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\* Attorney, Schiff, Hardin & Waite, Chicago; B.S., West Chester St. College; M.A., University of Pennsylvania (Wharton); J.D., University of Pennsylvania; LL.M., New York University.

1. STAFF OF SENATE COMM. ON FINANCE, 98TH CONG., 1ST SESS., THE REFORM AND SIMPLIFICATION OF THE INCOME TAXATION OF CORPORATIONS (Comm. Print 1983) [hereinafter cited as SFC REPORT].

2. AMERICAN LAW INSTITUTE, FEDERAL INCOME TAX PROJECT, SUBCHAPTER C: PROPOSALS OF THE AMERICAN LAW INSTITUTE ON CORPORATE ACQUISITIONS AND REPORTER'S STUDY ON CORPORATE DISTRIBUTIONS (1982).

The principal source for the description here of the manner in which the SFC Report would operate is the Senate Finance Committee's December 20, 1983 draft of a bill which contains the statutory language that would implement the merger and acquisition provisions of the SFC Report (this draft is hereinafter referred to as SFC Draft Bill).<sup>3</sup>

This paper is organized as follows. Section II deals with (1) the current definition of the term "reorganization," and (2) the proposed revision of the term "reorganization" and the proposed addition of the terms *Qualified Stock Acquisition* (QSA) and *Qualified Asset Acquisition* (QAA). Section III deals with (1) the current treatment of the taxpayers who participate in a reorganization, *i.e.*, the target's shareholders, the target, the acquiring corporation and any subsidiaries of the acquiring corporation, and (2) the proposed treatment of taxpayers who participate in a "reorganization," as such term is defined in the SFC Draft Bill, and in a QSA or a QAA. Section IV deals with (1) regular liquidations (*i.e.*, liquidations not involving a sale by the corporation of its assets) under current law, and (2) regular liquidations under the SFC Report. Section V deals with (1) section 337 sales and liquidations under present law, and (2) the analogue to the section 337 transaction under the SFC Report (*i.e.*, the QAA). Section VI deals with (1) stock purchases and the section 338 elective step-up in basis under current law, and (2) the analogue to section 338 under the SFC Report (*i.e.*, the QSA).

## SECTION II: CURRENT AND PROPOSED DEFINITION OF REORGANIZATION AND QAA AND QSA<sup>4</sup>

### *The Current Definition of "Reorganization"*

#### In General

The term "reorganization" is defined in section 368(a)(1) as (1) a statutory merger or consolidation (the (A));<sup>5</sup> (2) a stock for stock acquisition (the (B));<sup>6</sup> (3) a stock for asset acquisition (the (C));<sup>7</sup> (4) a split-up of a single corporation into two or more corporations

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3. The SFC Draft Bill was reported as Document 84-186 in TAX NOTES Jan. 9, 1984.

References here to proposed sections are references to provisions of the Internal Revenue Code of 1954 (the "Code"), as proposed to be amended by the SFC Draft Bill. References to conforming amendments to provisions of the Internal Revenue Code of 1954 are references to SFC Draft Bill sections.

4. The sections of this Article dealing with the current law are based on portions of S. THOMPSON, *FEDERAL INCOME TAXATION OF DOMESTIC AND FOREIGN BUSINESS TRANSACTIONS* (1980).

5. I.R.C. § 368(a)(1)(A) (1982).

6. I.R.C. § 368(a)(1)(B) (1982).

7. I.R.C. § 368(a)(1)(C) (1982).

(the (D));<sup>8</sup> (5) a recapitalization (the (E));<sup>9</sup> (6) a mere change in form (the (F));<sup>10</sup> and (7) a bankruptcy or insolvency reorganization (the (G)).<sup>11</sup>

Section 368(a)(2) provides special rules relating to the reorganization defined in section 368(a)(1). Section 368 says nothing about the treatment of the taxpayers involved in a reorganization; it merely describes transactions that are reorganizations. The tax treatment to the various taxpayers is discussed in Section III below.

In general, in a reorganization where only stock of the acquiring corporation is issued, all of the taxpayers (*i.e.*, the target, the target's shareholders and the acquiring corporation) have nonrecognition treatment.

### Current Continuity of Interest, Continuity of Business Enterprise and Business Purpose Requirements

Basically, reorganization transactions are shifts in corporate ownership in which the exchanging stockholder or security holder has a continuing interest in the corporation and has not merely been cashed out. For example, an acquiring corporation may acquire the stock of a target corporation by issuing its own stock to the target's shareholders. The target's former shareholders then have a continuing interest in the target, even though the direct ownership of the target has passed to the acquiring corporation. As will be seen below, the (B), (C), and the triangular reorganization under section 368(a)(2)(E) have statutorily mandated continuity of interest requirements. Further, courts have imposed a continuity of interest requirement.<sup>12</sup>

The courts and the Internal Revenue Service (the Service) have also developed a continuity of business enterprise requirement, which in essence requires the acquiring corporation to continue the target's historical business.<sup>13</sup> Furthermore, there is a business purpose requirement.<sup>14</sup>

8. I.R.C. § 368(a)(1)(D) (1982).

9. I.R.C. § 368(a)(1)(E) (1982).

10. I.R.C. § 368(a)(1)(F) (1982).

11. I.R.C. § 368(a)(1)(G) (1982).

12. See *e.g.*, *Helvering v. Minnesota Tea Co.*, 296 U.S. 378 (1935) (stock interest received must be "definite and material" and a "substantial part of the value of the thing transferred").

13. See, *e.g.*, *Treas. Reg. § 1.368-1(d)*, T.D. 7745, 45 Fed. Reg. 86,437 (1980).

14. See, *e.g.*, *Treas. Reg. § 1.368-1(b)*, T.D. 7745, 45 Fed. Reg. 86,437 (1980); *Gregory v. Helvering*, 293 U.S. 465 (1935).

## Current Types of Reorganizations

### *The (A) Merger Under Current Law*

Treasury Regulation section 1.368-2(b)(1) provides that in order to qualify as an (A) reorganization the merger or consolidation must be "effected pursuant to the corporation laws of the United States or a State or territory, or the District of Columbia."<sup>15</sup> Although the statute does not refer to the type of consideration the target's shareholders must receive, courts have held that the shareholders must receive a "continuity of interest" in the acquiring corporation (*i.e.*, a substantial stock interest). The Service's ruling position is that in order to satisfy the continuity of interest requirement in an (A) reorganization, the target's shareholders must receive a continuing interest through stock ownership in the acquiring corporation which is "equal in value . . . to at least 50 percent" of all of the formerly outstanding stock of the target.<sup>16</sup>

### *The Straight and Triangular (B) Stock for Stock Exchange Under Current Law*

In a (B) reorganization, the acquiring corporation issues "solely" its voting stock or "solely" the voting stock of its parent for stock of the target corporation amounting to "control" thereof. "Control" is defined in section 368(c)(1) as "80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the corporation." Transactions in which the consideration paid by the acquiring corporation is the voting stock of its parent corporation are generally known as triangular reorganizations. There are a variety of types of triangular reorganizations. In the following discussion, the term "Acquiring Subsidiary" refers to a subsidiary corporation that uses its parent's stock in making an acquisition. The parent is referred to as the "Acquiring Parent."

### *The Straight and Triangular (C) Stock for Assets Acquisition Under Current Law*

In a (C) reorganization, the acquiring corporation exchanges "solely" its voting stock or "solely" the voting stock of its parent for "substantially all of the properties" of the target corporation. The target corporation's liabilities are ignored in determining whether the transaction is "solely" for voting stock. The Tax Reform Act of 1984 added the requirement that the target corporation distribute "the stock, securities, and other properties it receives, as well as its

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15. Treas. Reg. § 31.368-2(b)(1), T.D. 7422, 41 Fed. Reg. 26,570 (1976).

16. Rev. Proc. 77-37 § 3.02, 1977-2 C.B. 568.

other properties, in pursuance of the plan of reorganization.”<sup>17</sup> The Secretary may waive this distribution requirement subject to any condition he may prescribe.<sup>18</sup>

The solely for voting stock requirement in a stock for asset (C) reorganization may be “relaxed” by section 368(a)(2)(B), which provides that 20% of the consideration paid by the acquiring corporation can be cash or other property (boot). In determining the amount of boot that can be utilized, liabilities of the target taken over by the acquiring corporation are counted as boot. The rule of section 368(a)(2)(B) is known in tax parlance as the “boot relaxation rule.”

*The Section 368(a)(2)(C) Over and Down Acquisition  
Under Current Law*

Section 368(a)(2)(C) provides that in (A), (B), (C) and (G) reorganizations, the stock or assets acquired by the acquiring corporation may be dropped down into a subsidiary of the acquiring corporation without disqualifying the transaction as a reorganization. In the absence of this provision, the transaction could not qualify as a reorganization because the continuity of interest would be too remote.<sup>19</sup> These types of transactions are sometimes referred to as “over and down” reorganizations. The “over” portion of the transactions is taxed in accordance with the principles discussed below; the “down” portion is a section 351<sup>20</sup> transaction (*i.e.*, a tax-free transfer to a controlled corporation).

*The Section 368(a)(2)(D) Forward Subsidiary Merger  
Under Current Law*

Section 368(a)(2)(D) provides that a merger of a target corporation into an Acquiring Subsidiary may qualify as an (A) reorganization provided (1) the Acquiring Subsidiary acquires in exchange for stock of the Acquiring Parent “substantially all” of the properties of the target, (2) the transaction would have been a merger if it had been made directly between the Acquiring Parent and the target,

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17. I.R.C. § 368(a)(2)(G)(i), added by Tax Reform Act of 1984, Pub. L. No. 98-369, § 363, 98 Stat. 494, 583 (1984).

18. I.R.C. § 368(a)(2)(G)(ii), added by Tax Reform Act of 1984, Pub. L. No. 98-369, § 363, 98 Stat. 494, 583 (1984).

19. *See Groman v. Commissioner*, 302 U.S. 82 (1937); *Helvering v. Bashford*, 302 U.S. 454 (1938).

20. I.R.C. § 351 (1982).

and (3) no stock of the Acquiring Subsidiary is used in the transaction. In providing for triangular mergers, section 368(a)(2)(D) expands the (A) reorganization in the same way the parenthetical clauses in both (B) and (C) expand those reorganizations to include triangular acquisitions. A transaction that comes within section 368(a)(2)(D) is sometimes referred to as a "forward subsidiary merger."

*The Section 368(a)(2)(E) Reverse Subsidiary Merger  
Under Current Law*

Section 368(a)(2)(E) provides that a merger of an Acquiring Subsidiary into a target corporation may qualify as an (A) reorganization if (1) after the merger the target corporation holds "substantially all of its properties and [substantially all] of the properties of the merged [Acquiring Subsidiary] corporation, (other than stock of the [Acquiring Parent] distributed in the transaction)," and (2) the former shareholders of the target exchange stock of the target amounting to control for voting stock of the Acquiring Parent. This transaction is sometimes referred to as a "reverse subsidiary merger."

*Summary of Current Acquisitive Reorganizations*

Each of the above types of transactions is acquisitive in nature; one corporation acquires either the stock or assets of another corporation. In summary, there are eight basic types of acquisitive reorganizations: (1) a straight merger between a target and an acquiror;<sup>21</sup> (2) a forward subsidiary merger of a target into an Acquiring Subsidiary;<sup>22</sup> (3) a reverse subsidiary merger of an Acquiring Subsidiary into a target;<sup>23</sup> (4) a straight stock for stock acquisition;<sup>24</sup> (5) a triangular stock for stock acquisition;<sup>25</sup> (6) a straight stock for asset acquisition;<sup>26</sup> (7) a triangular stock for asset acquisition;<sup>27</sup> and (8) an acquisition followed by a drop down into a subsidiary.<sup>28</sup>

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21. I.R.C. § 368(a)(1)(A) (1982).

22. I.R.C. § 368(a)(2)(D) (1982).

23. I.R.C. § 368(a)(2)(E) (1982).

24. I.R.C. § 368(a)(1)(B) (1982).

25. I.R.C. § 368(a)(1)(B) (1982).

26. I.R.C. § 368(a)(1)(C) (1982).

27. I.R.C. § 368(a)(1)(C) (1982).

28. I.R.C. § 368(a)(2)(C) (1982).

## *The Current (D) Reorganization*

### *In General*

In a (D) reorganization, a corporation (the "distributing corporation") transfers all or part of its assets to another corporation (the "controlled corporation"), and immediately after the transfer, the distributing corporation or its shareholders or a combination thereof are in control of the controlled corporation. The distribution by the distributing corporation to its shareholders of stock or securities of the controlled corporation must qualify under section 354,<sup>29</sup> 355,<sup>30</sup> or 356.<sup>31</sup>

### *The Current Nondivisive (D) Under Section 354(b)*

The (D) reorganization contemplated by section 354(b) is a transaction in which the distributing corporation (1) transfers "substantially all" of its assets to a corporation that is "controlled" by the distributing corporation or by one or more of its shareholders or any combination thereof, and (2) distributes pursuant to the plan of reorganization the stock or securities and other property received as well as its other properties. Thus, the distributing corporation is stripped of its assets and liquidated. This type of transaction is known as a nondivisive (D) reorganization. The Tax Reform Act of 1984 amends the definition of control for purposes of the nondivisive (D) to mean, in essence, 50% rather than 80% of the stock, and the section 318 attribution rules apply in determining whether the 50% test is met.<sup>32</sup>

### *The Current Divisive (D)*

Section 355 encompasses divisive (D) reorganizations in which there is a break-up of a corporation into two or more corporations as well as distributions of the stock of existing subsidiaries. If a transaction qualifies under section 355, the shareholders receive nonrecognition treatment on the distribution.

A (D) spin-off transaction may take place prior to and in preparation for an acquisitive reorganization.<sup>33</sup>

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29. I.R.C. § 354 (1982).

30. I.R.C. § 355 (1982).

31. I.R.C. § 356 (1982).

32. I.R.C. § 368(c)(2), added by Tax Reform Act of 1984, Pub. L. No. 98-369, § 364, 98 Stat. 494, 584 (1984).

33. See, e.g., *Commissioner v. Morris Trust*, 367 F.2d 794 (4th Cir. 1966).



### *The Current (E) Recapitalization*

The (E) reorganization is a recapitalization of a corporation; that is, a restructuring of the capital of a single corporation. For example, if the shareholders of a corporation exchange their common stock for new common stock, the transaction may constitute a recapitalization.<sup>34</sup>

The (E) generally will not be of any significance in an acquisitive reorganization. If, however, a corporation sells its assets to a commonly controlled sister corporation and then liquidates, the Service may view the transaction as both an (E) and (F).<sup>35</sup> If the transaction is so viewed, any cash or property received on the liquidation may be treated as a taxable dividend.

### *The Current (F) Mere Change in Form*

The (F) reorganization is a "mere change in identity, form, or place of organization of one corporation, however effected." For instance, a New York corporation reincorporates in Virginia. Under section 381(b)(3),<sup>36</sup> post-reorganization net operating losses can be carried back to a former corporation only in an (F).

### *The Current (G) Bankruptcy Reorganization*

Under section 368(a)(1)(G), a transfer by one corporation of all or part of its assets to another corporation in a bankruptcy or similar case will qualify as a reorganization provided that stock or securities of the corporation to which the assets are transferred are distributed in a transaction that qualifies under sections 354, 355 or 356.

Among the ways in which a (G) reorganization can be effectuated are the over and down triangular reorganization under section 368(a)(2)(C), the forward triangular merger under section 368(a)(2)(D), and the reverse triangular merger under section 368(a)(2)(E). Special rules relating to (G) reorganizations are set out in section 368(a)(3).

### *The Current Investment Company Provision*

Section 368(a)(2)(F) sets forth certain additional requirements concerning mergers of investment companies. Basically under this provision, a merger between investment companies may be treated as a taxable acquisition.

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34. See, e.g., Treas. Reg. § 1.368-2(e), T. D. 7422, 41 Fed. Reg. 26,570 (1976).

35. See Rev. Rul. 61-156, 1961-2 C.B. 62.

36. I.R.C. § 381(b)(3) (1982).

*Proposed Revision of Reorganization Concept*

## Proposed Definition of "Reorganization," "Control" and "Party to a Reorganization"

The SFC Report would amend section 368(a)(1) to include within the definition of reorganization only (1) a transfer of part or all of the assets of a corporation to another corporation (the Proposed (D));<sup>37</sup> (2) a recapitalization (the Proposed (E));<sup>38</sup> (3) a mere change in form (the Proposed (F));<sup>39</sup> and (4) a bankruptcy or insolvency reorganization (the Proposed (G)).<sup>40</sup>

Rules relating to bankruptcy and insolvency reorganizations similar to the rules of the current section 368(a)(3) are set out in proposed section 368(b), and rules similar to the investment company rules of current section 368(a)(2)(F) are set out in proposed section 368(e).

The requirements for the Proposed (D) are essentially the same as the requirements for the current (D). However, the definition of "control" under the proposed divisive (D) is 80% of the total number of shares of each class except nonvoting limited preferred,<sup>41</sup> rather than the current control definition in section 368(c), which is 80% of the total combined voting power of all classes entitled to vote and at least 80% of the total number of shares of all other classes.

The proposed nondivisive (D) would have a 50% test rather than an 80% test and section 318 would apply for purposes of determining whether the 50% test was satisfied.<sup>42</sup> Thus, this proposed control test is the same as that which applies to the current nondivisive (D) as a result of the amendment made by the Tax Reform Act of 1984. The Proposed (E) and (F) are the same as the current (E) and (F). The current eight forms of acquisitive reorganization set out above, would be stripped from the definition of reorganization. The term "party to a reorganization," which is determinative of the tax treatment to the parties, is defined to include (1) a party resulting from the reorganization, and (2) both corporations where there is a reorganization resulting from the acquisition of stock or assets.<sup>43</sup>

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37. Proposed § 368(a)(1).

38. Proposed § 368(a)(2).

39. Proposed § 368(a)(3).

40. Proposed § 368(a)(4).

41. Proposed § 368(d)(1).

42. Proposed § 368(d)(2).

43. Proposed § 368(c).

## Proposed Definition of QSA and QAA

The proposed definitions of QSA and QAA replace the eight forms of acquisitive reorganizations under current law and also replace sections 337<sup>44</sup> and 338<sup>45</sup> of current law.

### *Definition of QSA*

A QSA is defined as “any transaction or series of transactions during the 12-month acquisition period in which stock representing control of 1 corporation is acquired by another corporation.”<sup>46</sup> A transaction can qualify as a QSA without respect to the nature of consideration paid. The “12-month acquisition period” is the twelve-month period beginning with the date of the first acquisition of stock included in the acquisition.<sup>47</sup> “Acquisition date” means the first day on which there is a QSA.<sup>48</sup> “Control” is defined as at least 80% of the total number of shares of each class of stock other than nonvoting stock which is limited and preferred as to dividends.<sup>49</sup>

A reverse merger of a target into a direct or indirect subsidiary of the acquiring corporation where the target’s shareholders exchange stock of the target amounting to control thereof is treated as a QSA.<sup>50</sup> Also, as a result of making a QSA or QAA with respect to the target, the acquiring corporation is deemed to have made a QSA with respect to each controlled subsidiary of the target.<sup>51</sup> Thus a QAA with respect to the target will be a QSA with respect to any direct or indirect subsidiary of the target.<sup>52</sup>

A straight QSA is essentially the same as the straight (B) under current law, without the solely for voting stock requirement and with a codification of the twelve-month acquisition period which is set out in Treasury Regulation section 1.368-2(c).<sup>53</sup>

### *Definition of QAA*

A QAA is defined as (1) any statutory merger or consolidation, and (2) any transaction in which an acquiring corporation acquires at least 90% of the gross fair market value (FMV) and at least 70% of the net FMV of the target’s assets held “immediately before” the

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44. I.R.C. § 337 (1982).

45. I.R.C. § 338 (1982).

46. Proposed § 391(a).

47. Proposed § 393(a)(1).

48. Proposed § 393(a)(2).

49. Proposed § 393(c).

50. Proposed § 391(d).

51. Proposed § 391(c).

52. Proposed § 391(c)(2).

53. T.D. 7422, 41 Fed. Reg. 26,570 (1976).

transaction.<sup>54</sup> The statutory merger or consolidation part is the same as the current straight (A). The acquisition of assets part is the same as the straight (C), without the solely for voting stock requirement and the boot relaxation rules of current law, and with a codification of the Service's current ruling policy that "substantially all" means 90% of gross and 70% of net assets.<sup>55</sup> As is the case with a QSA, a transaction can qualify as a QAA without respect to the nature of the consideration.

*No Continuity of Interest or Business Enterprise  
Requirement and No Business Purpose Requirements*

Since there are no restrictions on the type of consideration that can be paid in a QSA or a QAA, there is no continuity of interest requirement. Also there is no continuity of business enterprise requirement or business purpose requirement for a QSA or QAA.<sup>56</sup>

Proposed Multi-corporate QSAs and QAAs

The triangular provisions of current law are in essence codified and broadened by providing that stock or assets of the target may be acquired by any corporation that is an affiliate of the acquiring corporation. The proposed statute says that except as provided in the regulations, an acquisition of a target's stock or assets by more than one member of the acquiring corporation's affiliated group is to be treated as made by the acquiring corporation.<sup>57</sup> Thus, for purposes of determining whether a QSA or QAA has taken place, the acquiring corporation is deemed to have acquired any of the target's stock or assets that are acquired by an affiliate of the acquiring corporation.

In general, the acquiring corporation is defined as the corporation that makes a QSA or a QAA.<sup>58</sup> However, where a target's assets are acquired by multiple corporations, the acquiring corporation is defined as the highest corporation in an "includable chain of corporations," provided the target's stock or assets are acquired only by corporations in such includable chain, or in any other case by the lowest-level common parent of the acquiring corporations.<sup>59</sup> The term "chain of includable corporations" means any corporation that

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54. Proposed § 391(b).

55. Rev. Proc. 77-37 § 3.011, 1977-2 C.B. 568.

56. SFC REPORT, *supra* note 1, at 59.

57. Proposed § 393(a)(7).

58. Proposed § 393(b)(1)(A).

59. Proposed § 393(b)(1)(B).

is in a chain of corporations for purposes of section 1504(a) or is the common parent with respect to the chain.<sup>60</sup>

The result of the above provisions is to permit the target's assets or stock to be acquired or held by any corporation in a group of 80% commonly controlled corporations that includes the acquiring corporation. As indicated above, a reverse merger of the target into a direct or indirect subsidiary of the acquiring corporation where the target's shareholders exchange stock of the target amounting to control is treated as a QSA.<sup>61</sup>

#### Proposed Definition of Party to the Acquisition

The term "party to the acquisition," which has significance in determining the tax treatment of the taxpayers in a QSA and a QAA, is defined to include the target corporation, the acquiring corporation and any corporation that is in control of the acquiring corporation as determined by applying the attribution rules of section 318(a) (without regard to section 318(a)(3)(C) or (4)).<sup>62</sup> As will be seen below in the discussion of the tax treatment of the various parties, this definition of "party to the acquisition" in essence allows the target's shareholders to receive nonrecognition treatment in a QSA or QAA on receipt of the stock of the acquiring corporation or of any corporation that is in direct or indirect control of the acquiring corporation. Thus, this definition together with the definition of the term acquiring corporation, discussed above, have the effect of overriding the *Groman* and *Bashford* cases.<sup>63</sup>

### SECTION III: CURRENT AND PROPOSED TAX TREATMENT OF TAXPAYERS INVOLVED IN A REORGANIZATION, A QSA, OR A QAA

#### *Current Tax Treatment of Target's Shareholders and Security Holders*

##### General Nonrecognition Rule of Current Law

Section 354(a)(1) gives the target's shareholders and security holders nonrecognition treatment upon an exchange pursuant to a "plan of reorganization" of stock or securities in such corporation for stock or securities in another corporation that is a party to a reorganization. The term "plan of reorganization" is not defined in the statute; the regulations say, however, that the plan must be "adopted" by each of the corporate parties thereto.<sup>64</sup> The term

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60. Proposed § 393(e).

61. Proposed § 391(d)(1).

62. Proposed § 393(d).

63. See *supra* text accompanying note 19.

64. Treas. Reg. § 1.368-3(a), T.D. 6622, 27 Fed. Reg. 11,918 (1962).

"party to a reorganization" is defined in section 368(b) to include all of the corporations involved in a reorganization under section 368(a).

### Exchange of Securities under Current Law

Section 354(a)(2)(A) limits the nonrecognition treatment for security holders to cases in which the principal amount of the securities received is equal to the principal amount surrendered. In the event cash or other property (boot) is received or the principal amount of the securities received exceeds the principal amount of the securities surrendered, then under section 356 the exchanging shareholder or security holder recognizes the gain realized to the extent of the boot and the fair market value of the excess principal amount of the securities received.<sup>65</sup>

### Property Attributable to Accrued Interest Under Current Law

Under section 354(a)(2)(B), if pursuant to a reorganization, a security holder receives stock, securities, or other property in respect of interest which has accrued on such securities during the period such security holder held the securities, then the amounts so received are treated as interest income. This principle applies whether or not the security holder realizes gain on the transaction.

### Treatment of Boot under Current Law

Under section 356(a)(1), a target's shareholder recognizes capital gain to the extent of the "boot" received (*i.e.*, money and fair market value of other property received). Boot that is in the form of installment obligations can qualify for installment sale treatment under section 453.<sup>66</sup>

Under section 356(a)(2), any gain recognized may be treated as a dividend, to the extent of the shareholder's pro rata share of the accumulated earnings and profits, if the exchange "has the effect of the distribution of a dividend." No loss is recognized.<sup>67</sup> As indicated in the discussion below of the treatment of boot under proposed law, the method for determining whether a transaction has the effect of a distribution of a dividend is uncertain under current law.

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65. I.R.C. § 356(a)(1), (d)(1), (d)(2)(A), (d)(2)(B) (1982).

66. I.R.C. § 453(f)(6) (1982).

67. I.R.C. § 356(c) (1982).

## Substituted Basis for Target's Shareholders Under Current Law

Under section 358, the exchanging shareholder or security holder who receives nonrecognition treatment under section 354 or partial nonrecognition treatment under section 356 takes the stock or securities received at a substituted basis, decreased by the amount of any boot received and increased by any gain recognized. The basis of the boot, other than money, is the fair market value thereof.<sup>68</sup>

### Example of Treatment of Target's Shareholders Under Current Law

Assume that individual (*S*) owns all the stock of target corporation (*TC*). The stock has a value of \$1 million, and *S*'s basis is \$100K ( $K = \$1,000$ ). *TC* merges into acquiring corporation (*AC*) in a transaction that qualifies as an (A) reorganization under section 368(a)(1)(A). *S* surrenders his *TC* stock and receives *AC* stock with a value of \$1 million. Under section 354, *S* has nonrecognition treatment, and under 358, *S* takes a substituted basis of \$100K for the *AC* stock.

Assume, on the other hand, that *S* receives \$900K of *AC* stock and \$100K in cash (boot). The transaction still constitutes an (A) reorganization; however, *S* has a recognized gain of \$100K under section 356(a)(1), and the gain might be treated as a dividend under section 356(a)(2). *S*'s basis under section 358(a) for his *AC* stock is \$100K (*i.e.*, the basis of this *TC* stock (\$100K), minus the cash received (\$100K), plus the gain recognized (\$100K)). Since the value of his *AC* stock is \$900K, *S* has deferred \$800K of his gain.

If, for example, *S* had received \$800K in cash and \$200K of *AC* stock, the transaction would not qualify as a reorganization because of an absence of a continuity of interest. As a consequence, the nonrecognition and boot gain rules of sections 354 and 356 would not apply.<sup>69</sup> *S* would, therefore, have a taxable exchange.

### *Proposed Tax Treatment of Target's Shareholders and Security Holders*

#### General Nonrecognition Rule Under Proposed Law

Under the SFC Draft Bill a target's shareholders in a QSA or a QAA would receive nonrecognition to the extent stock or securities of a corporation which is a "party to the acquisition" are exchanged

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68. I.R.C. § 358(a)(2) (1982).

69. *Turnbow v. Commissioner*, 368 U.S. 337 (1961) (holding that a reorganization is a precondition to the availability of the boot gain rule of section 356).

solely for stock or securities of the target.<sup>70</sup> This is essentially the same as the rule of current section 354(a), except there is no plan of reorganization requirement, and in lieu of "a party to the reorganization" there is the concept of "a party to the acquisition." Since the term "party to the acquisition" includes any corporation that is in direct or indirect control of the acquiring corporation, the target's shareholders can receive nonrecognition treatment on the receipt of stock of any of such controlling corporations. Because of the structure of the definition of "reorganization" under current law, nonrecognition treatment is available for the stock of only one corporation, that is, the acquiring corporation or its direct parent. Section 354(a) is retained for reorganization transactions under proposed section 368.

The proposed law makes it clear that for purposes of determining whether the target shareholders have nonrecognition treatment, the term QSA includes the acquisition of the stock of a target where immediately after the acquisition the acquiring corporation has control of the target, whether or not the acquiring corporation had control immediately before the acquisition.<sup>71</sup> This is a codification of the provisions of the definition of the current (B) reorganization which allows the creeping (B).<sup>72</sup> The effect of this provision is to give the target's shareholders the benefit of nonrecognition treatment in such a transaction, even though the transaction does not qualify as a QSA for purposes of the elective cost or carryover basis treatment at the target's corporate level, which is discussed below. If the transaction is not a QSA for purposes of the cost or carryover basis election, then the target's assets will automatically retain their basis.

### Exchange of Securities Under Proposed Law

The SFC Draft Bill contains the same limitation on the excess principal amount of securities received in a QSA or QAA that are contained under current sections 354(a)(2), 356(d) and 356(a) for excess principal amount of securities received in a reorganization.<sup>73</sup> Thus, an excess principal amount of securities received is treated as boot and triggers gain recognition. The current sections 354(a)(2), 356(d) and 356(a) are retained for reorganizations under proposed section 368.

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70. Proposed § 397(a).

71. Proposed § 397(b).

72. Treas. Reg. § 1.368-2(c), T.D. 7422, 41 Fed. Reg. 26,570 (1976).

73. Proposed §§ 397(c), 398(a), 398(d).



## Property Attributable to Accrued Interest Under Proposed Law

The SFC Draft Bill contains the same treatment for property attributable to accrued interest that is contained in current section 354(a)(2)(B).<sup>74</sup>

## Treatment of Boot Under Proposed Law

### *General Principles*

The SFC Draft Bill contains the same boot gain rule that is contained in section 356(a)(1).<sup>75</sup> However, the SFC Draft Bill eliminates the gain limitation on the amount of boot that can be treated as a dividend under current section 356(a)(2). The SFC Draft Bill also codifies the Service's view of the method for determining both the amount of a dividend and whether an exchange has the effect of a distribution of a dividend under current section 356(a)(2).

Under the SFC Draft Bill, if an exchange has the effect of a dividend, then the recipient of the boot is treated as having received a dividend equal to the lesser of (1) the boot received, or (2) his ratable share of the undistributed earnings and profits (E & P) of *both* the target and the acquiring corporations.<sup>76</sup> Under current law, the Service has been contending that it is proper to look at the E & P of both corporations under section 356(a)(2). The Tax Court's position is that only the transferor's E & P is considered in determining the amount of E & P for section 356(a)(2) purposes.<sup>77</sup> The Fifth Circuit has held that in a (D) reorganization the E & P of both the distributing and the controlled corporations are counted for purposes of section 356(a)(2).<sup>78</sup> There is a conforming amendment to current section 356 which will apply to reorganizations under proposed section 368.<sup>79</sup>

The SFC Draft Bill also provides that for purposes of determining whether a distribution has the effect of a distribution of a dividend, the target's shareholders are treated as having transferred in the QSA or QAA the target's stock in exchange solely for stock of the acquiring corporation and thereafter the shareholders are treated as having received the boot in a redemption of its stock by the acquir-

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74. Proposed § 397(c)(2).

75. Proposed § 398(a)(1).

76. Proposed § 398(a)(2)(A).

77. See *American Manufacturing Co. v. Commissioner*, 55 T.C. 204 (1970); *Atlas Tool Co. v. Commissioner*, 70 T.C. 86 (1978) (both of which dealt with (D) reorganizations).

78. *Davant v. Commissioner*, 366 F.2d 874 (5th Cir. 1966), *cert. denied*, 386 U.S. 1022 (1967).

79. SFC Draft Bill § 201(a).

ing corporation in a transaction that is governed by section 302.<sup>80</sup> Thus, the proposals would codify the principle set out in *Wright v. United States*.<sup>81</sup> In *Wright* the Eighth Circuit held that in determining whether a boot distribution in an acquisitive reorganization has the effect of the distribution of a dividend within the meaning of section 356(a)(2), the distribution is considered as though it were made by the acquiring corporation. Thus, the target's shareholders are treated as if (1) the only consideration they receive is stock of the acquiror, and (2) immediately thereafter the acquiror redeems a portion of their stock with the boot. Where the acquiror is large relative to the target, the distribution is likely to qualify as a section 302(a) redemption. In Revenue Ruling 75-83,<sup>82</sup> the Service announced that it would not follow *Wright* and that "it will continue to view" boot distributions as having been made by the target corporation.

In *Shimberg v. United States*<sup>83</sup> the Fifth Circuit held that a pro rata distribution of boot to the target's shareholders gave rise to dividend treatment under section 356(a)(2). The taxpayer-shareholder controlled 68% of the target but only 1% of the acquiror. The court said:

and we decline to apply on a wholesale basis the "meaningful reduction" test in cases arising under § 356(a)(2). . . . A contrary holding would render § 356(a)(2) virtually meaningless when a large corporation swallows a small one in reorganization, for there will always be a marked decrease in control by the small corporation's shareholders, unless the same shareholders control both corporations . . . .

If a pro rata distribution of profits from a continuing corporation is a dividend, and a corporate reorganization is a "continuance of the proprietary interests in the continuing enterprise under modified corporate form," it follows that the pro rata distribution of "boot" to shareholders of one of the participating corporations must certainly have the "effect of the distribution of a dividend" within the meaning of § 356(a)(2) . . . .<sup>84</sup>

There is a conforming amendment to current section 356 with respect to determining dividend equivalency which will apply to reorganizations under proposed section 368.<sup>85</sup>

In the event a target's shareholder receives stock of more than one party to an acquisition (*i.e.*, more than one member of the acquiring corporation's affiliated group) then the E & P of each such party is

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80. Proposed § 398(a)(3).

81. 482 F.2d 600 (8th Cir. 1973).

82. 1975-1 C.B. 112.

83. 577 F.2d 283 (5th Cir. 1978).

84. *Id.* at 287-88.

85. SFC Draft Bill § 201(b).

taken into account in computing the amount of the dividend, and the target's shareholder is treated as having exchanged stock for stock of the party which is at the highest level in the chain.<sup>86</sup>

### *Exception to Gain Recognition Where Parent Disposes of Subsidiary*

In the case of a QSA where a corporate shareholder transfers stock of a target amounting to control (e.g., where a parent transfers the stock of a subsidiary in a QSA), the parent does not recognize any gain or loss on receipt of boot if the transaction is treated as a Stepped-Up Basis Acquisition, as defined below, or in the case of a Carryover Basis Acquisition, as defined below, if the parent and any other distributee make a liquidating distribution within a twelve-month period of all of its assets (other than assets retained to meet claims).<sup>87</sup> The purpose of this provision is to prevent double tax on the same gain. For example, if a selling parent corporation was taxed on boot received in a QSA that is a Stepped-Up Basis Acquisition there would be a double tax because, as noted below, the target subsidiary is also subject to tax. The parent takes an FMV basis for any stock of the acquiring corporation received in such an acquisition.<sup>88</sup>

Also, in the case of a QSA that is treated as a Carryover Basis Acquisition (which means that the target does not recognize gain or loss), if the selling parent is taxed on any boot received there is a double tax because the subsidiary's built-in gain will at some point in the future be taxed. As noted above, in order for the selling parent to avoid taxation in this situation it must liquidate within twelve months.<sup>89</sup>

### *Substituted Basis for Target's Shareholders Under Proposed Law*

The SFC Draft Bill contains a substituted basis provision that is essentially the same as current section 358.<sup>90</sup> The current section 358 is retained for reorganizations under proposed section 368.

### *Example of Treatment of Target's Shareholders Under Proposed Law*

The treatment of the target's shareholder under proposed law is essentially the same as the treatment under current law as illustrated in the example above under Section III, with the following principal

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86. Proposed § 398(a)(4).

87. Proposed § 398(c).

88. Proposed § 399(a)(3).

89. Proposed § 398(c)(2).

90. Proposed § 399(a)(1), (a)(2).

exceptions. First, there is certainty in the determination whether the transaction has the effect of a dividend. Second, the shareholder can have nonrecognition treatment for stock received without respect to the amount of stock received. Therefore, if the shareholder in the above example received \$800K in cash and \$200K of AC stock, the shareholder would have a taxable gain (and possibly a dividend) of \$800K and nonrecognition of \$100K.<sup>91</sup> The basis for his stock would be \$100K — the starting basis for his stock (\$100K) less the boot received (\$800K), plus the gain recognized (\$800K).<sup>92</sup>

### *Current Tax Treatment of the Acquiring Corporation*

#### *Treatment of Acquiring Corporation In A Straight Acquisitive Reorganization Under Current Law*

Section 1032 provides for nonrecognition treatment upon the issuance of stock by a corporation. Also, no gain is recognized by a corporation upon the issuance of its securities.<sup>93</sup> Under section 362(b),<sup>94</sup> the acquiring corporation's basis for stock or assets received is a carryover basis, increased by the amount of any gain recognized by the transferor.

#### *Treatment of Acquiring Corporation and Acquiring Subsidiary In Triangular Reorganizations Under Current Law*

When an Acquiring Parent contributes its stock to an Acquiring Subsidiary for use by the subsidiary in a triangular acquisition of the (B), (C), (a)(2)(D) or (a)(2)(E) type, the parent receives a substituted basis of zero for the subsidiary's stock,<sup>95</sup> and the subsidiary receives a carryover basis of zero for the parent's stock.<sup>96</sup> Both corporations are protected from recognition on the exchange by section 1032.<sup>97</sup> When the subsidiary uses the parent's stock in the acquisition, the subsidiary takes a carryover basis for the target's stock or assets received.<sup>98</sup> There is no provision in the Code, however, that gives the parent a reciprocal carryover basis for the subsidiary's (or surviving target's) stock. Thus, the parent's basis for such stock

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91. Proposed §§ 397(a), 398(a).

92. Proposed § 399.

93. Treas. Reg. § 1.61-12(c)(1), T.D. 7741, 45 Fed. Reg. 81,745 (1980).

94. I.R.C. § 362(b) (1982).

95. I.R.C. § 358(a) (1982).

96. I.R.C. § 362(a) (1982).

97. Rev. Rul. 74-503, 1974-2 C.B. 117.

98. I.R.C. §§ 362(b) (parenthetical phrase); 358(e) (parenthetical phrase).

would be zero. Furthermore, there is no Code section that gives the subsidiary nonrecognition on the issuance of its parent's stock.

On January 2, 1981 the Treasury issued proposed regulations under section 358 and section 1032, which deal with this zero basis problem.<sup>99</sup> Basically, Proposed Regulation section 1.1032-2 provides that the Acquiring Subsidiary does not recognize gain upon the issuance of its parent's stock in a triangular reorganization. Proposed Regulation section 1.358-6 provides generally that in the case of triangular (C)s and (a)(2)(D)s, the Acquiring Parent's basis for the Acquiring Subsidiary's stock is the same basis as the stock would have had if the the Acquiring Parent had acquired the target's assets and liabilities directly and then dropped those assets and liabilities into the Acquiring Subsidiary in an over and down acquisition under section 368(a)(2)(C).<sup>100</sup> This is referred to in the regulations as the "net basis" of the target's assets, that is, the sum of the target's cash plus the adjusted basis for its assets less its liabilities.<sup>101</sup> In a triangular (B), the Acquiring Parent's basis in the stock of the Acquiring Subsidiary is increased by the former shareholders' bases of the target shares acquired by the Acquiring Subsidiary.<sup>102</sup> In a reverse subsidiary merger under section 368(a)(2)(E), the Acquiring Parent's basis for the target's stock is generally the same as the net basis of the target's assets.<sup>103</sup>

### *Proposed Tax Treatment of Acquiring Corporation*

#### Treatment of Acquiring Corporation in a Straight QSA or QAA Proposed Law

##### *Nonrecognition Treatment*

The acquiring corporation has nonrecognition under the current section 1032 upon the issuance of its stock in a QSA or a QAA. It also has nonrecognition under current Treasury Regulation section 1.61-12(c) upon the issuance of its securities.

##### *Acquiring Corporation's Basis in a QAA*

In a QAA the acquiring corporation's basis for the target's assets is dependent upon whether the acquisition is a Carryover Basis Acquisition or a Stepped-Up Basis Acquisition. In the case of a QAA where no Stepped-Up Basis Election (SUB-Election) is made, the

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99. 46 Fed. Reg. 112 (1981) (to be codified at 26 C.F.R.) (proposed January 2, 1981), *reprinted in* 4 Fed. Taxes (P-H) ¶ 18,214; 7 Fed. Taxes (P-H) ¶ 31,684.

100. Proposed Reg. § 1.358-6(a).

101. Proposed Reg. § 1.358-6(a)(4).

102. Proposed Reg. § 1.358-6(b).

103. Proposed Reg. § 1.358-6(c).

transaction is treated as a Carryover Basis Acquisition.<sup>104</sup> The SUB-Election is discussed below.

In a QAA that is a Carryover Basis Acquisition, the acquiring corporation or any affiliate of the acquiring corporation takes a carryover basis for the target's assets.<sup>105</sup> In a QAA for which the SUB-Election is made and, consequently, the transaction is treated as a Stepped-Up Basis Acquisition, the acquiring corporation takes a cost basis for the target's assets. This result comes under the present section 1012. As will be seen below, in a Stepped-Up Basis Acquisition the target has gain recognition.

### *Acquiring Corporation's Basis in a QSA*

In any QSA, whether a Carryover Basis Acquisition or a Stepped-Up Basis Acquisition, the acquiring corporation's basis for the target's stock is equal to the net adjusted basis of the target's assets.<sup>106</sup> This section provides that at any particular time the basis of a parent for the stock of a controlled subsidiary is equal to the parent's "applicable percentage of the net adjusted basis of the assets of the controlled corporation at such time."<sup>107</sup> This provision applies generally and not just in QSAs. The net adjusted basis is the subsidiary's adjusted basis for its assets properly adjusted under regulations for the subsidiary's liabilities and other "relevant terms."<sup>108</sup> The term applicable percentage is defined as the percentage of the subsidiary's stock by value that is held by a parent.<sup>109</sup> Control for purposes of this provision means at least 80% of the total combined voting power of all classes of the subsidiary's stock that is entitled to vote and at least 80% of the total number of shares of all other classes except nonvoting stock which is limited and preferred as to dividends.<sup>110</sup>

### *The SUB-Election for QSAs and QAAs*

The SUB-Election is made by the acquiring corporation in a QSA.<sup>111</sup> Both the acquiring corporation and the target, except as noted below, must make the SUB-Election in a QAA.<sup>112</sup> As noted

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104. Proposed § 392(a).

105. Proposed § 396(a).

106. Proposed § 1020(a).

107. *Id.*

108. Proposed § 1020(b)(1).

109. Proposed § 1020(b)(2).

110. Proposed § 1020(c).

111. Proposed § 392(b)(1).

112. Proposed § 392(b)(1).

below in the discussion of the consistency requirement, the SUB-Election is made separately for the target and for each of its controlled subsidiaries. Thus, there is entity electivity with respect to the SUB-Election.

If a QAA is effectuated as a merger or consolidation, the target is not required to elect unless the target is a member of a selling consolidated group.<sup>113</sup> The SUB-Election cannot be made with respect to a QAA if before the acquisition the acquiring corporation is a member of the same controlled group of corporations as the target.<sup>114</sup> However, if the acquiring corporation acquires from unrelated parties at least 50% in value of the target's stock during a twelve-month period ending on the acquisition date, the SUB-Election can be made with respect to a QAA.<sup>115</sup> Thus, for example, if the acquiring corporation purchases 60% of the target's stock in a tender offer that occurs within a twelve-month period, the SUB-Election could be made for a subsequent merger (*i.e.*, the QAA) of the target into the acquiring corporation. However, if the target's stock has been held for more than a year at the time of the merger (*i.e.*, the QAA), the SUB-Election could not be made and the acquiring corporation would take a carryover basis for the target's assets. The time for making the SUB-Election is the later of the fifteenth day of the ninth month after the acquisition or the time specified in regulations.<sup>116</sup>

### *Consistency Requirement for SUB-Election*

There is a consistency requirement for both QSAs and QAAs. Under this rule, if the acquiring corporation acquires during the "consistency period" (as defined below) an asset that was held by the target corporation at any time during the twelve-month period ending on the acquisition date, then the asset is treated in the same manner as if it had been held by the target at the time of the acquisition.<sup>117</sup>

In the case of a QSA, the consistency period is (1) the one-year period before the beginning of the twelve-month acquisition period, (2) the acquisition period, and (3) the one-year period after the acquisition date.<sup>118</sup> In the case of a QAA, the consistency period is the period consisting of the one-year period before and after the acquisi-

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113. Proposed § 392(b)(2)(B).

114. Proposed § 392(b)(3)(A). Under Proposed section 392(b)(3)(C), control here means ownership of at least 50% of the stock.

115. Proposed § 392(b)(3)(B).

116. Proposed § 392(d).

117. Proposed § 392(c).

118. Proposed § 393(a)(5)(A).

tion date.<sup>119</sup> The acquisition date is the first day on which there is a QSA or a QAA.<sup>120</sup>

The operation of this consistency provision can be illustrated as follows. Assume that on February 1, 1985, the acquiring corporation purchases an asset from the target, and on April 1, 1985, the acquiring corporation acquires the target in a QSA or a QAA for which the SUB-Election is not made. The QSA or QAA is, therefore, a Carryover Basis Acquisition. Since (1) the acquiring corporation acquired the asset during the consistency period, and (2) the asset was purchased, but the QSA or QAA is a Carryover Basis Acquisition, the asset is treated as part of the QSA or QAA. Therefore, the acquiring corporation takes a carryover basis for the asset<sup>121</sup> and the target has no gain or loss on the sale of the assets, provided in the case of a QAA that the target liquidates within twelve-months.<sup>122</sup> On the other hand, if the SUB-Election were made with respect to this acquisition, the target would have gain recognition,<sup>123</sup> and the acquiring corporation would have a cost basis for the asset.

The above rule does not apply if the asset acquired from the target is stock of a subsidiary of the target that is acquired in a QSA.<sup>124</sup> Thus, if in the above example the asset that was acquired was stock of a subsidiary of the target in a QSA of such subsidiary, and if the SUB-Election has been made with respect to such subsidiary, the fact that the subsequent QAA with respect to the target was done as a Carryover Basis Acquisition would have no effect on the prior Stepped-Up Basis Acquisition of the subsidiary. Thus, this rule reverses the anti-selective step-up in basis rules of present section 338.

The SFC Report explains that the cost or carryover basis election is to be made on a corporation-by-corporation basis. This result is apparently reflected in the SFC Draft Bill in the following manner. First, as noted above, the consistency requirement does not apply to an acquisition of stock of a subsidiary of a target.<sup>125</sup> Second, an acquiring corporation is treated as owning stock of a corporation under section 318 and is treated as "acquiring such stock on the first date on which [the acquiring corporation] is considered as owning such

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119. Proposed § 393(a)(5)(B).

120. Proposed § 393(a)(2).

121. Proposed § 396(a).

122. Proposed § 394(a), (b).

123. Proposed § 395(a), (b).

124. Proposed § 392(c)(2)(A).

125. Proposed § 392(c)(2)(A).



stock.”<sup>126</sup> Consequently if an acquiring corporation has a QAA or a QSA with respect to a target, there is automatically a QSA for any 80% direct or indirect controlled subsidiary of the target.<sup>127</sup> Therefore, a SUB-Election could be made separately with respect to the target and to each of its controlled subsidiaries.

However, in the case of an acquisition of a target in a QSA or a QAA where (1) the acquiring corporation also has made a QSA of a target affiliate (as defined below) during the consistency period, and (2) the target affiliate holds an asset that was held by the target during the twelve-month period ending on the acquisition date, such asset is treated in the same manner as if it had been held by the target at the time of the acquisition of the target.<sup>128</sup> The term “target affiliate” is defined as any corporation that was at any time during the consistency period in the same affiliated group with the target.<sup>129</sup>

Thus, for example, assume that on February 1, 1985 a target drops an asset into a subsidiary, and the acquiror corporation immediately acquires all of the stock of the subsidiary in a QSA. The acquiring corporation makes a SUB-Election with respect to the subsidiary. On April 1, 1985, the acquiring corporation acquires the target in a QSA or QAA and does not make the SUB-Election. In such case the asset that was contributed to the subsidiary would be treated as if it had been acquired in the Carryover Basis Acquisition of the target. This rule prevents abuse of the entity election provision by preacquisition transfers of assets within the target group.

#### Treatment Of the Acquiring Corporation And Its Subsidiaries in Multi-Corporation QSAs and QAAs

The proposals would amend the current section 1032(a) to provide that an issuing corporation does not have gain or loss upon the issuance of stock of a corporation that is in direct or indirect control of such issuing corporation.<sup>130</sup> Thus, section 1032 is expanded significantly. Since a parent's basis for its subsidiary's stock is at all times equal to the net adjusted basis of the subsidiary's assets,<sup>131</sup> there is an automatic adjustment to the parent's basis for the subsidiary's stock in an acquisition by the subsidiary of the target's stock or assets.

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126. Proposed § 393(a)(6).

127. Proposed § 391(c).

128. Proposed § 392(c)(2)(B).

129. Proposed § 393(a)(3).

130. Proposed § 1032(a)(20).

131. Proposed § 1020.

*Current Tax Treatment of the Target*

If a target exchanges its property solely for stock of an acquiring corporation, then under section 361(a),<sup>132</sup> the target does not recognize any gain or loss. Under section 361(b), if the target receives both stock and boot, the target recognizes the gain realized to the extent of the boot, unless the boot is distributed to its shareholders. Pursuant to section 357(a), liabilities transferred from a target to an acquiring corporation do not constitute boot in the absence of tax avoidance motives.<sup>133</sup> Under section 358, the basis to the target corporation of the stock or securities it receives from the acquiring corporation is a substituted basis, decreased by the boot received and increased by the gain recognized. If the target is acquired in a (B) reorganization then there will be no change in the basis of the target's assets.

*Proposed Tax Treatment of the Target**In General*

The tax treatment of the target in a proposed section 368 reorganization is the same as the tax treatment outlined above. The tax treatment of the target in a QSA or QAA will depend upon whether the transaction is a Carryover Basis Acquisition or a Stepped-Up Basis Acquisition.

*QAAs that are Carryover Basis Acquisitions*

A Carryover Basis Acquisition is defined to include a QAA with respect to which a SUB-Election is not made.<sup>134</sup> Proposed section 394(a) provides that except as provided in proposed section 394(b), in the case of a Carryover Basis Acquisition the target corporation generally does not recognize gain or loss.

Under proposed section 394(b)(1) the target recognizes gain or loss in a QAA that is a Carryover Basis Acquisition if it does not liquidate "within the twelve-month period beginning on the acquisition date." In the event the target does not liquidate within the required twelve-month period, the amount of gain the target recognizes is equal to the lesser of the target's "net gain" or the sum of the boot received; that is the "money and the fair market value of

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132. I.R.C. § 361(a) (1982).

133. I.R.C. § 357(b) (1982).

134. Proposed § 392(a).

other property (other than stock of a party to the acquisition) received by the target corporation.”<sup>135</sup> The “net gain” is defined as the amount of gain the target would have recognized in a straight sale over the amount of loss it would have recognized.<sup>136</sup> Thus, if the target receives no boot in the transaction, it does not have to liquidate to receive nonrecognition treatment.

Any gain is treated as long-term capital gain.<sup>137</sup> The net gain concept and long-term capital gain treatment amends the fragmentation rule of *Williams v. McGowan*.<sup>138</sup>

If the target corporation is a controlled subsidiary, then all of the controlling corporations in the chain of corporations must also liquidate within such twelve-month period in order for the target to have nonrecognition treatment with respect to any boot received.<sup>139</sup> This provision is similar to the current section 337(c)(3).

### QAAs That Are Stepped-Up Basis Acquisitions

If a SUB-Election is made, with respect to a QAA, then the target corporation recognizes gain or loss in the transaction.<sup>140</sup> The character and amount of the gain here is determined under the fragmentation rule of *Williams v. McGowan*. The SUB-Election in the context of QAA is discussed further below in Section V, which deals with a sale of the target’s assets followed by liquidation.

### QSAs That Are Carryover Basis Acquisitions

A target recognizes no gain or loss in a QSA that is a Carryover Basis Acquisition.<sup>141</sup>

### QSAs That Are Stepped-Up Basis Acquisitions

The treatment of the target and subsidiaries of the target in a QSA for which a SUB-Election is made is discussed below in Section VI. As noted there, the target or subsidiary recognizes gain or loss.

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135. Proposed § 394(b)(2).

136. Proposed § 394(b)(4).

137. Proposed § 394(b)(3).

138. 152 F.2d 570 (1945).

139. Proposed § 394(b)(1)(B).

140. Proposed § 395(b).

141. Proposed § 394(a).

SECTION IV: CURRENT AND PROPOSED PROVISIONS CONCERNING  
REGULAR LIQUIDATIONS*The Current Provisions Concerning Regular Liquidations*Current Tax Treatment to Shareholders on Regular  
Liquidations

Upon a complete liquidation of a corporation, the shareholder generally recognizes capital gain or loss.<sup>142</sup> The shareholder takes a fair market value basis for the property received.<sup>143</sup> There is no statutory definition of "complete liquidation"; however, section 346 provides that "a distribution shall be treated as in complete liquidation of a corporation if the distribution is one of a series of distributions in redemption of all of the stock of the corporation pursuant to a plan."<sup>144</sup> If the corporation is a "collapsible corporation" (a device for converting ordinary income into capital gain), any long-term capital gain recognized upon a sale of stock or liquidation is treated as ordinary income.<sup>145</sup>

Not all liquidations are taxable to the shareholders. A liquidation completed within "one calendar month" may be nontaxable under section 333, and the shareholder takes a modified substituted basis for the property received.<sup>146</sup> Moreover, a liquidation of an 80% controlled subsidiary into a parent corporation is nontaxable under section 332, and the parent takes a substituted basis for the subsidiary's assets.<sup>147</sup>

## Current Tax Treatment to Liquidating Corporation

Pursuant to section 336, a corporation generally does not recognize income upon liquidation. This codifies the *General Utilities*<sup>148</sup> doctrine in the liquidation context. Gain is recognized, however, with respect to recapture of depreciation, LIFO reserves, and tax benefit items. The Tax Reform Act of 1984 revises section 311 to generally reverse the *General Utilities* principle in the context of current distributions by providing that gain is generally recognized by the distributing corporation on any ordinary, non-liquidating distribution or

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142. I.R.C. §§ 331, 1001 (1982).

143. I.R.C. § 334(a) (1982).

144. I.R.C. § 346 (1982).

145. I.R.C. § 341 (1982).

146. I.R.C. § 334(c) (1982).

147. I.R.C. § 334(b)(1) (1982).

148. *General Utilities & Operating Co. v. Helvering*, 296 U.S. 200 (1935).

redemption.<sup>149</sup>

### *The Proposed Provisions Concerning Regular Liquidations*

#### Proposed Tax Treatment to Shareholders on Regular Liquidations

Shareholders would continue to have capital gain or loss under section 331 upon the liquidation of a corporation. The collapsible corporation provisions would be repealed, except with respect to foreign collapsible corporations.<sup>150</sup> Section 333 would also be repealed.<sup>151</sup> A parent corporation would continue to qualify for nonrecognition treatment under section 332 upon the liquidation of an 80% controlled subsidiary.

#### Proposed Tax Treatment to Liquidating Corporations

Section 336 is repealed.<sup>152</sup> Section 311 is amended to govern both current and liquidating distributions.<sup>153</sup> The distributing corporation recognizes gain on any current or liquidating distribution with respect to its stock.<sup>154</sup> Loss is recognized in the case of a distribution that is "pursuant to a plan of complete liquidation."<sup>155</sup> Gain or loss is determined in the same manner "as if the property distributed had been sold to the distributee at its fair market value."<sup>156</sup> It should be noted that both the SFC Report and the ALI Report would exempt goodwill from tax on liquidating sales and distributions, but the SFC Draft Bill does not have any such exception. The repeal of section 336 gives rise to a double tax on liquidation. A distributee corporation does not recognize gain if the distribution is a section 355 tax-free spin-off transaction.<sup>157</sup> In the context of liquidating distributions the distributee corporation does not have recognition when the distribution is to a controlling parent corporation that takes a carryover basis under section 334(b).<sup>158</sup>

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149. I.R.C. § 311(d) as amended by Tax Reform Act of 1984, Pub. L. No. 98-369, § 354, 98 Stat. 494, 568-69 (1984).

150. SFC Draft Bill § 111(d).

151. SFC Draft Bill § 111(c)(1).

152. SFC Draft Bill § 111(c)(2).

153. See SFC Draft Bill § 111(a)(1).

154. Proposed § 311(a)(1).

155. Proposed § 311(a)(2).

156. Proposed § 311(a)(3).

157. Proposed § 311(d).

158. Proposed § 311(c).

SECTION V: CURRENT AND PROPOSED TAX TREATMENT UPON  
SALE OF CORPORATION'S ASSETS FOLLOWED BY LIQUIDATION*Current Tax Treatment of the Target and Its Shareholders Upon  
Sale of Its Assets and Liquidations*

Under section 337, a corporation (other than a collapsible corporation) that adopts a plan of liquidation and liquidates within twelve months may receive nonrecognition treatment on a sale of its assets occurring after the adoption of the plan, except with respect to certain recapture items. This provision is designed to relieve the pressure of determining whether a distribution to shareholders followed by a sale of assets is in fact a sale by the corporation under *Commissioner v. Court Holding Co.*,<sup>159</sup> or alternatively, a sale by the shareholders under *United States v. Cumberland Public Service, Co.*<sup>160</sup>

The shareholders of the corporation have capital gain under section 331 unless the corporation is collapsible.

*Proposed Tax Treatment To The Target Corporation and Its  
Shareholders Upon Sale Of its Assets Followed By Liquidation.*

In a sale of assets by a target corporation that qualifies as a QAA, the target's shareholders will have the treatment discussed above for QAAs; that is, they have nonrecognition treatment to the extent they exchange stock or securities in the target for stock or securities in the acquiring corporation, and they have gain and possibly a dividend with respect to any boot received.<sup>161</sup>

Section 337 is repealed.<sup>162</sup> Consequently, in general, a target corporation has gain or loss on the sale of its assets even though such sales are made as part of a liquidation. However, if the target corporation disposes of its assets in a QAA and if a SUB-Election is not made, then the transaction is treated as a Carryover Basis Acquisition sale provided the target is liquidated within a twelve-month period.<sup>163</sup> As noted above, in the context of a sale by a target corporation of its assets, a QAA is defined as a transaction in which an acquiring corporation acquires "at least (A) 90% of the gross [FMV] and (B) 70% of the net [FMV] of the assets of the [target corporation] held immediately before such transaction." Also, as

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159. 324 U.S. 331 (1945).

160. 338 U.S. 451 (1950).

161. Proposed §§ 397, 398.

162. SFC Draft Bill § 111(c)(3).

163. Proposed § 394(a), (b).

noted above, a transaction can qualify as a QAA without respect to the nature or mix of consideration paid by the acquiring corporation. If a SUB-Election is made, with respect to a QAA, then the target corporation recognizes gain or loss in the transaction.<sup>164</sup> Unlike the SFC Report and the ALI Report, there is no exception for good will.

As indicated in Section III above, a SUB-Election in a QAA is made by both the acquiring corporation<sup>165</sup> and the target corporation.<sup>166</sup> The SUB-Election may not be made if the acquiring corporation and the target are members of the same controlled group of corporations before the QAA.<sup>167</sup> Control here means ownership of 50% of the stock.<sup>168</sup> However, this exception for commonly controlled corporations does not apply if the acquiring corporation acquired from an unrelated party at least 50% of the FMV of the target's stock during the twelve-month period ending on the acquisition date.<sup>169</sup>

Except where an election is made pursuant to regulations, a target corporation that makes a SUB-Election will "not be treated as a member of an affiliated group with respect to the gain or loss on the acquisition."<sup>170</sup> The effect of this provision is to prevent the target corporation from using losses from other members to offset the taxable gain from the transaction, except where a proper election is made. This provision is similar to the rule of present section 338(H)(9).

It should be noted that if, for example, the acquiring corporation pays cash for the target's assets in a QAA for which the SUB-Election is made, there will be a full tax on the transaction at both the corporate and shareholder levels.

## SECTION VI: CURRENT AND PROPOSED TAX TREATMENT UPON PURCHASE OF TARGET'S STOCK

### *Current Tax Treatment to the Target Corporation and Its Shareholders Upon Purchase of Its Stock Followed by Section 338 Election*

The target's stockholders have capital gain or loss on the sale of their stock, unless the target is a collapsible corporation. Upon the purchase of a target corporation's stock there is no change in the basis of its assets unless a section 338 election is made. Thus, a purchase of stock without more could be viewed as a carryover basis

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164. Proposed § 395(b).

165. Proposed § 392(b)(1).

166. Proposed § 392(b)(2).

167. Proposed § 392(b)(3).

168. Proposed § 392(b)(3)(C).

169. Proposed § 392(b)(3)(B).

170. Proposed § 395(c).

transaction. Under section 338, which replaces section 334(b)(2), if an acquiring corporation purchases at least 80% of the stock of a target corporation within a twelve-month period and the acquiror thereafter makes an election under section 338, the target is treated as selling its assets to itself in a transaction qualifying under section 337, in which case the target is treated as a new corporation with a stepped-up basis for its assets. Under the consistency requirement, the section 338 step-up rule applies to all controlled subsidiaries of the target.<sup>171</sup>

*Proposed Tax Treatment of the Target Corporation and Its Shareholders Upon Purchase of Its Stock*

Provided the transaction qualifies as a QSA, the target's shareholders are treated as outlined in Section III above. That is, they have nonrecognition treatment to the extent they receive stock or securities of the acquiring corporation in exchange for stock or securities of the target.

Section 338 is repealed.<sup>172</sup> Upon the purchase of a target corporation's stock there is no change in the basis of its assets, unless there is a QSA and a SUB-Election is made. In the absence of a SUB-Election the transaction is treated as a Carryover Basis Acquisition.<sup>173</sup> The SUB-Election in a QSA is made by the acquiring corporation.<sup>174</sup> The election must be made before the later of the fifteenth day of the ninth month following the month in which the acquisition occurs or the date prescribed in the regulations.<sup>175</sup> This is similar to section 338(g).

As noted above in Section III, there is no consistency requirement like the anti-selectivity provision contained in the present section 338; an acquiring corporation may, therefore, make entity-by-entity SUB-Elections for the target and the target affiliates. If the SUB-Election is made with respect to the target or any of its controlled subsidiaries, such corporation is treated (1) as having sold all of its assets at the close of the acquisition date in a transaction in which gain or loss is recognized, and (2) as being a new corporation that purchased all of such assets as of the beginning of the day after the

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171. I.R.C. § 338(e), (f) (1982).

172. SFC Draft Bill § 111(c)(4).

173. Proposed § 392(a).

174. Proposed § 392(b)(1).

175. Proposed § 392(d).



acquisition date.<sup>176</sup> This is similar to the concept in section 338(a). The assets are deemed to be sold and purchased for their FMV on the acquisition date.<sup>177</sup> In the case of a SUB-Election, a target is not treated as a member of a consolidated selling group, unless an appropriate election pursuant to the regulations is made.<sup>178</sup> The SFC Draft Bill also contains a provision that would allow a non-corporate purchaser of stock of a target to make a SUB-Election.<sup>179</sup>

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176. Proposed § 395(a).

177. Proposed § 395(a)(2).

178. Proposed § 395(c)(1), (c)(2).

179. Proposed § 395(c)(3).